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No. 86-88

In The
Supreme Court of the United States
October Term, 1986

CITICORP INDUSTRIAL CREDIT, INC.,
Petitioner,
v.

WILLIAM E. BROCK, SECRETARY OF LABOR, UNITED STATES DEPARTMENT OF LABOR,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR NATIONAL COMMERCIAL FINANCE ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Amicus National Commercial Finance Association will address the following question:

Whether Section 15(a)(1) of the Fair Labor Standards Act of 1938 (29 U.S.C. § 215(a)(1)) should be construed to modify the priority of creditors' claims against the assets of an insolvent debtor.

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INTEREST OF AMICUS

The National Commercial Finance Association ("NCFA") is a non-profit membership corporation organized under the laws of Delaware, with its principal office in New York.[1] NCFA is the national trade association for financial institutions that provide asset-based commercial financing and factoring. It has more than 230 members, including petitioner Citicorp Industrial Credit, Inc. ("Citicorp") and substantially all of the major "money center" and regional banks, small commercial lenders, and large publicly-held commercial lenders.

Members of the NCFA operate on a national, regional and local scale, providing both operating funds and acquisition financing to businesses, often through the financing of accounts receivable and inventory on a revolving basis. Many of these businesses are small and medium-sized enterprises which depend upon the availability of secured financing for their existence and growth. For example, inventory financing may allow a borrower to purchase inventory needed for cyclical or seasonal buildups or to supplement cash needs during periods of low volume. Similarly, secured acquisition financing in leveraged buyouts has played a major role in the decentralization and revitalization of many enterprises in relatively mature

[1] This Brief is filed with the consent of the parties; letters reflecting consent are on file with the Clerk.

manufacturing industries, and the growth of new technology in modest-sized companies.[2]

Secured financing is a significant part of the national credit market. Total outstanding financing by the commercial finance industry has increased from under $1 billion in 1955, to more than $55 billion in 1985.

The holding of the United States Court of Appeals for the Sixth Circuit in this litigation effectively establishes a secret wage lien with priority over a prior perfected security interest in inventory collateral. That holding directly affects each of the members of NCFA, and threatens serious disruption of long-established commercial practices in the asset-based financing industry.

STATEMENT

Asset-based lending in the United States today depends upon the existence of adequate collateral and the notoriety of liens on collateral securing the loans. Before extending credit, therefore, secured lenders conduct lien

[2] *See generally* Dodsworth, *How Mr. Simon Opened the Floodgates: U.S. Leveraged Buyouts,* Financial Times, Dec. 5, 1985 at 14 ("leveraged buyouts . . . have taken Wall Street by Storm"); Williams, *Leveraged Buyouts Outpace Purchases by Private Concerns,* Wall St. J., Aug. 12, 1985 at 13, Col. 2; DeAngelo & DeAngelo, *The Numbers Show Everyone Profits,* N.Y. Times, Jan. 22, 1984 Section 3 at 2, Col. 2; Brown, *Leveraged Buyouts 1983's Rage,* Wash. Post, Dec. 7, 1983 at D8, Col. 3; Waters, *The Leveraged Buyout Boom, Inc.,* Sept. 1983 at 46; *Why Leveraged Buyouts Are Getting So Hot,* Bus. Wk., June 27, 1983 at 86.

searches in the states and counties in which the prospective borrowers' collateral may be located or moved, typically including the location of the borrowers' manufacturing or selling facilities. These searches are accomplished quickly and efficiently by reviewing public records maintained at state and local government offices to determine the extent to which any prior claims would affect the lender's rights to the collateral. This procedure provides assurance that the prospective lender's interests will not be inferior to unanticipated earlier filed liens and security interests.

The lender-borrower relationship is defined by contract. In the case of large lenders these contracts, or financing agreements, can be extensive. Typically, the agreement, among other things, establishes a security interest and requires the borrower to take all steps necessary to enable the lender to perfect that security interest. In addition, such an agreement typically contains various warranties by the borrower, may provide for limited monitoring by the lender of the collateral, and specifies the lender's rights and remedies in the event of default.

Lenders require the filing of financing statements in various state and local governmental offices to perfect their security interests and thereby make their own secured positions notorious to others doing business, or contemplating doing business, with the borrower.

Monitoring of the collateral can take two forms. The primary monitoring is done by periodic reporting in writing by the borrower to the lender regarding the collateral. Large, more sophisticated lenders may conduct periodic on-site inspections and reviews of certain corporate financial records. Small secured lenders frequently do no such

on-site monitoring, relying solely on information supplied by borrowers. Such reporting and monitoring is generally limited to attempting to determine the borrower's compliance with the terms of the financing agreement, and the amount of lending availability which exists based upon the collateral.[3] Lenders generally exercise no control over how funds advanced are used by the borrower.

On-site monitoring by the lender is, however, limited both by necessity and design. Maintaining a staff of examiners or auditors on the premises of each borrower would be prohibitively expensive for lenders, and therefore ultimately for borrowers. Borrowers would obviously find such a constant intrusion into their businesses by lenders to be meddlesome and undesirable. Because secured lenders run the risk of having their interest in collateral subordinated by reviewing courts if they intrude too deeply into their borrowers' affairs, lenders likewise are not interested in such arrangements. Lenders must place a good deal of reliance, therefore, on the good faith reporting of their borrowers.

By taking the above steps, lenders seek to protect themselves against "hidden" liens and to assure repayment of their loans. The new federal wage lien imposed by the Sixth Circuit, however, is both "hidden" and indeterminate as to amount. Lenders really cannot, therefore, account for this new lien in any quantifiable way, other than to restrict available credit and seek lending opportunities in capital-intensive, rather than labor-intensive industries.

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3 Lending availability is calculated by applying a percentage advance rate to the collateral.

SUMMARY OF ARGUMENT

Commercial lenders rely upon well understood and established law to determine how much credit to extend to borrowers and to set the advance and interest rates. The Uniform Commercial Code, adopted in forty-nine states, Puerto Rico and the District of Columbia, provides stability and predictability of legal consequences in making lending decisions in the complex area of secured lending.

The Sixth Circuit disregards decades of settled law and expectations by holding that the hot goods provision of the FLSA may be invoked against a foreclosing secured creditor. The Sixth Circuit ruling gives a super-priority and secret lien to unpaid wage claims of employees whose rights, like those of secured lenders, already are protected by state and federal law specifically governing the priority of creditors' claims against an insolvent debtor's assets. There is no basis in the purpose or policy of the FLSA for invoking Section 15(a)(1) against secured creditors.

The Fair Labor Standards Act wage lien established by the Sixth Circuit significantly alters existing lender-borrower relationships, and will have an even greater impact on future transactions. In addition to contractual changes, lenders may be forced to attempt to monitor the payroll practices of their borrowers more closely in the hope of reserving available credit for employee wage claims. If monitoring were permitted, and if it led to significant lender participation in the management decisions of the borrower, the lender risks subordination of its claims in bankruptcy. Furthermore, the increased

risk to the lender posed by potential employee wage claims would mean less available credit and higher interest rates for borrowers, and greater administrative expense for secured lenders.

The lender's need to attempt to estimate and withhold reserves for the unlimited and uncontrollable risk of unpaid wages is likely to be most serious for borrowers in temporary financial difficulties. Such businesses, particularly in labor-intensive industries, may be unable to obtain the capital needed to recover. Thus, another consequence of the Sixth Circuit's decision may be premature closing of businesses that might otherwise have survived, with resultant loss of employment.

Without any evidence that the FLSA was intended to address an insolvent employer's financial inability to pay agreed wages in excess of the minimum wage rates prescribed in the Act, or that Congress ever considered modifying the priority of creditors' claims against an insolvent debtor's assets, the Sixth Circuit adopted an unprecedented construction of Section 15(a)(1) that not only preempts the well-established body of state law that traditionally governed creditors' rights, but also conflicts with other federal statutes specifically addressing creditors' rights. To do so, the Sixth Circuit rejected the clear distinction between wage and hour standards governed by the FLSA and creditors' rights laws—a distinction that has existed since the FLSA was enacted. Furthermore, the Sixth Circuit adopted its novel reading of Section 15(a)(1) without any suggestion that the bright line firmly established in the *Powell Knitting* decision 20 years ago had been the source of any difficulty, either in the administration of the FLSA or in the achievement of the Act's purpose to establish minimum wage rates.

ARGUMENT

THE FAIR LABOR STANDARDS ACT SHOULD NOT BE CONSTRUED TO MODIFY THE RELATIVE PRIORITY OF CREDITORS' CLAIMS AGAINST THE ASSETS OF INSOLVENT DEBTORS.

A. Powell Knitting Was Correctly Decided in 1966.

Twenty years ago the Second Circuit correctly rejected the position the Secretary has revived in this litigation.[4] In *Wirtz v. Powell Knitting Mills*, 360 F.2d 730 (2d Cir. 1966), the Secretary moved to restrain Powell Knitting Mills and its secured creditor, Meinhard Commercial Corp., from violating Section 15(a)(1) of the FLSA by transporting goods claimed to have been produced in violation of the minimum wage provisions of the Act.[5] The district court denied relief. The Second Circuit affirmed, holding that a secured creditor could not be enjoined under

[4] Amicus National Commercial Finance Association fully subscribes to the argument that the Fair Labor Standards Act was not intended to address the relative priority of creditors' claims against the assets of insolvent debtors, which is presented in the brief on the merits submitted by petitioner. Accordingly, that discussion is not repeated here.

[5] As in this litigation, the tenuous "violation" asserted was the insolvent employer's financial inability to pay agreed wages in excess of the statutory minimums prescribed in the FLSA—or, indeed, any wages at all.

Section 15(a)(1) of the FLSA from enforcing its lien on inventory collateral by sale.

The Second Circuit excepted "foreclosing" secured creditors from the FLSA, although it acknowledged that a "wooden" reading of the FLSA could produce an opposite result. The Court found no connection between the asserted violation of the FLSA and the foreclosing secured creditor, and refused to condone the Secretary of Labor's "backhanded" attack on Meinhard's secured position. 360 F.2d at 732; *accord, Shultz v. Factors, Inc.*, 65 Lab. Cas. (CCH) ¶ 32,487 (4th Cir. 1971); *Dunlop v. Sportsmaster, Inc.*, 77 Lab. Cas. (CCH) ¶ 33,293 (E.D. Tenn. 1975).

In *Powell Knitting*, the Second Circuit recognized the distinction that has existed since the FLSA was enacted 50 years ago between creditors' rights law and wage and hour legislation. That distinction is as compelling today as it was in 1966. There is no reason to reconsider the well-settled rule of law firmly established in *Powell Knitting*.

B. Establishing a Federal Wage Lien Would Produce Significant and Undesirable Consequences for the Commercial Finance Industry That Congress Could Not Have Intended.

1. State and federal laws governing the priority of creditors' claims are well-established and provide the stability essential to the industry.

Commercial finance industry practices and financial products are based on the well-established body of state and federal laws specifically governing the priority of creditors' claims against the assets of insolvent debtors. Article 9 of the Uniform Commercial Code, the Bankruptcy

Code, and the Federal Tax Lien Act of 1966 are three of the principal sources of law in this area. The substantive and remedial provisions of the Fair Labor Standards Act, however, were directed at the unrelated problems of oppressive wages paid and hours imposed by ongoing businesses. Overlaying the Fair Labor Standards Act in the complex area of creditors' rights law will seriously disrupt existing commercial practices, and may produce significant changes in the practices and products of asset-based commercial lenders.

In evaluating a proposed loan transaction, reliable assessment of risk is fundamental to rational decision-making. One significant factor in evaluating the risk of asset-based financing is the amount of any senior claims against the prospective borrower's assets. If the borrower suffers financial difficulties, senior claims will be paid first. Therefore, in evaluating a proposed loan it is essential for a lender to be able to identify other claims against the assets, and the relative priority of those claims to his own.

Article 9 of the Uniform Commercial Code provides the stability and certainty that are essential to the availability of modern secured lending, particularly to small businesses for which credit otherwise might be unavailable. The UCC permits commercial lenders to determine the risks associated with proposed loans from superior liens quickly and efficiently by reviewing public filings. Two of the most significant achievements of the UCC are: first, the virtual elimination of "secret" liens; and, second, the establishment of readily ascertainable rules governing the priority of claims to assets. In addition, the UCC permits flexible security devices designed to satisfy modern com-

mercial needs. The UCC is a truly national law of commerce: it has been adopted in 49 states, Puerto Rico, and the District of Columbia.

Secret liens are antithetical to a sophisticated market for credit and other financial services. The filing system for recording security interests established under the UCC is critical to the operation of the modern commercial lending industry. *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 739 (1979). The filing system, together with the priority rules established in Article 9, have made the problems caused by secret liens insignificant. Similarly, prior to the almost universal enactment of the UCC, disputes over the relative priority of creditors' claims were common. For the most part, those disputes have been resolved by the UCC with respect to personal property interests, such as inventory collateral. Under Article 9, a perfected security interest is senior to an unsecured claim for wages, and therefore the security interest would be paid in full before a wage claimant could receive any of the proceeds of the collateral. *See* Uniform Commercial Code § 9-301.

The Federal Tax Lien Act of 1966, 26 U.S.C. § 6321, *et seq.* is another of the principal statutes on which the practices of the commercial financing industry rest. The Tax Lien Act establishes a detailed set of rules governing the relative priority of private security interests and those of the United States. Under the tax lien statute a prior perfected security interest is senior to a tax lien. *See* 26 U.S.C. § 6323(a), (c).

The federal Bankruptcy Code, 11 U.S.C. § 101, *et seq.*, is another important source of law on which the practices

and offerings of the commercial financing industry depend. The Bankruptcy Code prescribes the order of priority for claims to the assets of a bankrupt. Under the Bankruptcy Code, a perfected security interest holder is senior to wage claimants and, except under very carefully limited circumstances, the security interest is not subject to impairment in bankruptcy proceedings. See pages 16-17, *infra*.

2. The FLSA wage lien will disrupt the operation of law governing the priority of creditors' claims and significantly affect commercial lending practices.

Under the Sixth Circuit rule, the newly created Fair Labor Standards Act wage lien is senior to a prior perfected security interest, thus reversing the order of priority prescribed under the UCC, the Bankruptcy Code, and the Tax Lien Act.

Because the wage lien created by the Sixth Circuit is "secret," a prospective creditor has no practical means of identifying the lien. It arises upon an employer's nonpayment of wages, without any action on the part of the employee. When a prospective creditor proposes to advance money he has no way of knowing whether the borrower has failed to pay his employees or, more importantly, whether at some point in the future he will fail to do so, thus creating a superior wage lien.

Further, the wage lien is unlimited and unpredictable in amount. The proceeds from a secured creditor's inventory collateral may be totally consumed by employee wage claims. The lien is also unpredictable in another sense. Its existence depends entirely on the action of the Secre-

tary in filing suit under § 15(a)(1). Thus, the risk of the Fair Labor Standards Act wage lien is totally outside the control of the creditor, and there is no practical way for a secured creditor to protect against it.

In addition, if a Congress chose to legislate a lien similar to the one created by the Sixth Circuit, it would certainly be defined and limited in ways unlike a *de facto* lien created by judicial fiat. Such legislation could borrow from state legislation which restricts employee wage liens to certain dollar "caps"[6] or to employees of particular industries.[7]

Judicial legislation of a claim, with no accompanying guidelines of how and to what extent such a claim would apply is a matter previously addressed by this Court with great caution. For example, this Court has repeatedly been reluctant to imply private rights of action in federal statutes, absent clear congressional intent that such a right should be implied. *California v. Sierra Club,* 451 U.S. 287, 294 (1981); *Universities Research Ass'n v. Coutu,* 450 U.S. 754, 770-84 (1981); *Transamerica Mortgage Advisors, Inc. v. Lewis,* 444 U.S. 11, 16-21 (1979); *Touche Ross & Co. v. Redington,* 442 U.S. 560, 576 (1979); *Cort v. Ash,* 422 U.S. 66, 79 (1975). There is no evidence of congressional intent to apply Section 15(a)(1) to secured lenders.[8]

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6 *See* Del. Code Ann. Tit. 10, § 4931 (1975) (New Castle County, $50 and one month); Minn. Stat. § 514.59 (West 1986 Supp.) ($1,000 or five weeks net wages up to $3,000, whichever is greater).

7 *See* Ala. Code § 35-11-90 (1977) (railroad employees); Miss. Code Ann. § 85-7-1 (1985 Supp.) (agricultural employees).

8 *See* discussion at pp. 19-38 of Citicorp's Brief.

Accordingly, the Sixth Circuit rule will affect both existing and prospective loan transactions. As to existing loans, the new wage lien threatens the adequacy of security for money already advanced. Agreements premised on the claims outstanding at the time the transaction was entered and then existing rules as to priority must be revisited in light of the potential risk of employee wage claims. Even then, however, it may not be possible to modify existing agreements to protect creditors.

The impact as to prospective agreements may be even more substantial. A potential lender may rely on the absence of claims on file against the assets of the prospective borrower only at his peril. The potential for employee wage claims is always present. Because the risk is not only out of the control of the lender, but almost impossible to estimate in advance for purposes of establishing adequate reserves, in some cases, such as in highly labor intensive businesses, the risk may be beyond feasible and commercially acceptable bounds for both borrower and lender. The result will be no financing. In other cases, to take into account the wage lien risk, lenders may demand more collateral or higher interest rates than the borrower can agree to. Again the result will be no financing.

The increased risks associated with inventory financing may lead some creditors to restrict the availability of such financing. Financing with inventory as collateral has become a standard means of obtaining working capital. Inventory and accounts receivable formed the basic collateral for Citicorp's loan to Ely in this case. Financing of that type would be diminished as a consequence of the

new FLSA wage lien. Further, it can be expected that lenders will tend to shift their working capital loans away from labor intensive industries. In a labor intensive industry, the borrower is likely to have a proportionately larger payroll compared to collateral value. Lenders can be expected to try and reduce the risk of secret wage liens by preferring to lend more to capital intensive businesses.

The restriction or possible unavailability of capital to borrowers who may be unable to obtain it elsewhere could not have been contemplated or intended by Congress when the FLSA was enacted in 1938. Such consequences have nothing to do with the purposes for which the FLSA was enacted: to establish minimum wage rates and decent working conditions.

C. Enforcing Section 15(a)(1) Against an Innocent Secured Creditor Will Not Further the Purposes of the FLSA.

1. There is no practical means for a secured creditor to police compliance by its debtors with the substantive requirements of the FLSA.

One response to the increased risk posed by the prospect of senior employee wage claims could be closer monitoring of the borrower's payroll practices, with an accompanying increased expense of administering loans. In the ordinary course, however, a lender becomes aware of its borrower's failure to pay employee wages only after the damage is done and, under the holding of the Sixth Circuit, the Secretary is entitled to an injunction against the sale of inventory collateral. In some cases, lenders advance funds and during the term of the financing agreement receive periodic reports from the borrower. Even

under those circumstances, however, the lender is not likely to learn of a missed payroll until weeks after the event, if at all. Even if the lender's examiner (if it has one) resided permanently on the borrower's premises throughout the term of the loan, the examiner would merely learn of the missed payroll earlier. He could not prevent it, particularly when financial collapse is the cause of the failure (except by advancing additional funds to pay wages, with no expectation of repayment). Furthermore, such extensive monitoring, coupled with action to direct payment to particular creditors, may produce claims that the secured lender should be subordinated to the rights of other creditors by its exercise of dominion or control over a borrower's business.[9] Thus, increased monitoring produces increased expense and additional risk, without preventing unpaid workers when an employer goes broke.

2. Shifting the risk of loss due to an employer's insolvency to creditors furthers no purpose of the FLSA.

The principal purpose of the FLSA was to establish minimum wage rates for employees. It has nothing to do with the priority of creditors' claims against the assets of an insolvent. There is no basis for the implicit assumption, that, in enacting the FLSA, Congress decided to prefer employee wage claims over prior perfected security in-

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9 *See Taylor v. Standard Gas & Electric Company,* 306 U.S. 307 (1939); *In re Process-Manz Press,* 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on jurisdictional grounds,* 369 F.2d 513 (7th Cir. 1966), *cert. denied sub nom Limperis v. A.J. Armstrong Co.,* 386 U.S. 957 (1967); A. DeNatale and P. Abram, *The Doctrine of Equitable Subordination as Applied to Non-Management Creditors,* 40 Business Lawyer 417, 432-445 (1985).

terests. Moreover, the policy choice Congress made in the Bankruptcy Act, when it did choose between preferring employees and secured creditors, suggests the opposite conclusion.

Neither the insolvent borrower nor the secured lender who will sell the goods (often at distress prices) without reference to their cost of production would be influenced by the incentive Section 15(a)(1) seeks to create, namely, encouraging compliance with the wage and hour provisions by taking the profit out of noncompliance. As in the instant case of an insolvent debtor and foreclosing secured creditor, which is typical, the debtor cannot profit because it is out of business. The secured creditor sells the goods for the best price available, which will be the same whether employee wages are paid or not.[10]

D. The Sixth Circuit Rule is Contrary to Policies Expressed in Other Federal Statutes.

1. Security interests are given priority in other federal statutes.

a. *Bankruptcy Code.* As already noted, a perfected security interest is senior to a wage claim under the Bankruptcy Code. In addition, under Section 364(d) of the Bankruptcy Code, 11 U.S.C. § 364(d), a Chapter 11 debtor may incur a debt that is secured by a lien on the debtor's property that is senior or equal to a perfected security interest only in limited and carefully-defined circumstances. Before such a new lien may be granted, Section 364(d)(1)

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[10] *See* Samuelson, *Economics* at 380 (8th ed. 1970) ("Once a bridge is built it must earn what the traffic will bear regardless of past sunk costs."); McConnell, *Economics* at 472-73 (9th ed. 1984).

requires notice, a hearing, and adequate protection of the secured party's interest.

b. *Tax Lien Act.* The federal tax lien statutes, 26 U.S.C. § 6321 *et seq.,* provide for a lien for unpaid taxes upon all of a taxpayer's property and interests in property. Section 6323 of the Internal Revenue Code, 26 U.S.C. § 6323, governs the priority of the federal tax lien and contains extensive provisions protecting the priority status of certain commercial transaction financing agreements, and recognizes the senior priority of prior perfected security interests, with limited exceptions.

The federal insolvency priority statute, 31 U.S.C. § 3713, expressly provides that these claims "[s]hall be paid first. . ." in liquidation proceedings, other than under the Bankruptcy Code. The unsecured federal claim has not been given priority over a prior perfected consensual lien, such as a security interest in inventory. It is difficult to conceive of a legal basis to elevate unpaid wages over unpaid federal claims. These statutes demonstrate that where Congress intends to intervene and disturb the claim priorities established by state law, it is clear in its intent and language.

2. The Sixth Circuit rule is inconsistent with the intended operation of other federal statutes.

If the "secret lien" for wages which the Sixth Circuit's rule creates were condoned, so that "hot goods" could not be sold in interstate commerce by all "persons" without exception, as decreed below:

(i) a trustee in bankruptcy could not sell inventory without first paying wages, contrary to the Bankruptcy Code;

(ii) the Internal Revenue Service could not sell inventory of a taxpayer subject to a tax lien, if there were unpaid wages; and

(iii) unpaid sellers under the Perishable Agricultural Commodities Act (7 U.S.C. § 499e(c)) and the Packers & Stockyards Act (7 U.S.C. § 196(b)) could not sell inventory processed by a defaulting buyer without first paying the wages of employees of that buyer.

These are incredible results that follow from the Sixth Circuit's reading of the intended operation of Section 15(a)(1), and could not have been intended by Congress. A secured party with a valid perfected security interest in inventory collateral, which advanced funds before any default in payment of wages and which did not control the use of the borrower's funds, is in the same position as the trustee in bankruptcy, the IRS agent, and the unpaid sellers of cattle and commodities. Federal and state statutes explicitly governing the right to dispose of property for the benefit of a secured creditor, lien creditor, and trustee for all creditors establish the priority of these claims without ambiguity.

Congress could not have intended to supersede or amend these statutes when it enacted the FLSA.

CONCLUSION

For the foregoing reasons, the judgment of the Sixth Circuit should be reversed.

Respectfully submitted,

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